State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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LFC INVESTMENT REPORT FOR THE QUARTER ENDING DECEMBER 31, 2013

This report details the comparative investment performance of the three investment agencies: the Educational Retirement Board (ERB), the Public Employees Retirement Association (PERA), and the State Investment Council (SIC). It explains how the returns generated by the three investment agencies differed from that of the archetypical fund and how their management and consultants added or subtracted value. Long-term performance is an important metric, and therefore this report includes fund returns and comparative rankings for the one-year, three-year, five-year, and ten-year periods and attribution analysis for the quarter and the one and three-year periods.

The Trust Universe Comparison Service (TUCS) reports robust gains for global stock markets in the fourth quarter of 2013, ending a year of consistently positive returns across all four quarters. According to TUCS, the U.S. economy continued to show signs of increased strength. Real Gross Domestic Product grew at an impressive annual rate of 4.1 percent in the third quarter motivated by the momentum of the solid 2.5 percent growth rate in the second quarter. Consumer inflation measured through the Consumer Price Index – All Urban Consumers (CPI-U) shows prices actually fell in the fourth quarter (-0.47 percent). Future growth prospects remain optimistic in the face of all economic sectors, indicating the U.S. economic recovery is on solid footing. In its December meeting, the Federal Open Market Committee announced plans to begin contraction of its monetary stimulus of $75 billion-per-month bond purchasing program by $10 billion per month, starting in January 2014.

TUCS notes the U.S. stock market, represented by the Wilshire 5000 Total Market Index, posted a total return in the fourth quarter of 10.11 percent compared to 6.03 percent in the third quarter. 2013 ended with a total return of 33.06 percent, reflecting its best annual results since 1995. Bond yields drifted down in October then reversed course and rose in November and December. The front runner 10-year U.S. Treasury yield ended the year at 3.04 percent, its highest level since July 2011 a full 126 basis points higher than its yield at year-end 2012.

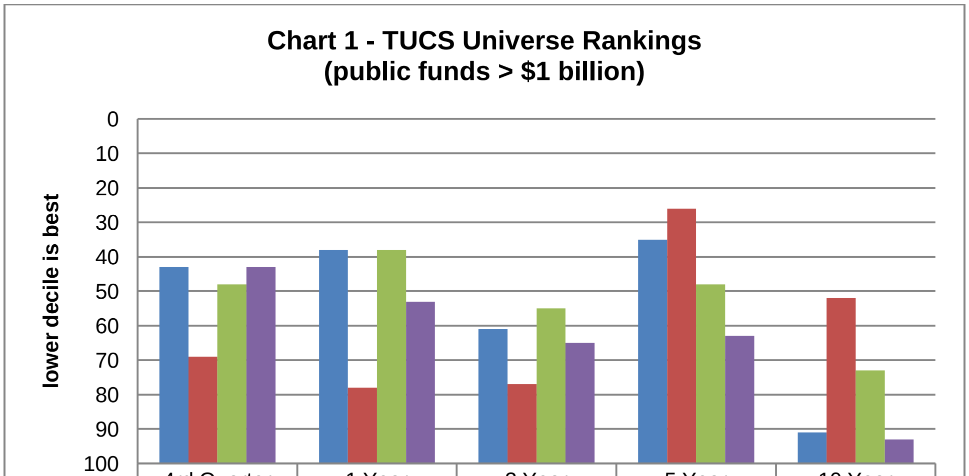
Returns and Ending Balances. Table 1 shows the respective funds' ending balances and compares the investment agencies' returns for the quarter and the one, three, five, and ten-year periods. The annual target returns for the three investment agencies are 7.5 to 7.75 percent. Although the agencies' returns for the quarter fall below the target, the one, three, and five-year returns exceed the target. Ten-year returns include lesser investment performance in the aftermath of the recession and are lower than the target.

Table 1				
Returns and Ending Balances as of December 31, 2013				
Returns (%)	PERA	ERB	LGPF	STPF
Quarter	5.34	4.38	5.11	5.23
1-Year	16.54	11.96	16.28	15.61
3-Year	9.46	8.64	9.68	9.34
5-Year	12.67	13.29	12.49	11.83
10-Year	6.30	7.17	6.78	6.10
Ending Balance ($B)	11.74	9.42	13.36	4.47

Source: Investment Agency Reports

The returns and balances of the Severance Tax Permanent Fund (STPF) and Land Grant Permanent Fund (LGPF) are shown separately. A portion of the STPF is invested in Economically Targeted Investments (ETIs) that typically yield below-market because the investments are not targeted solely at delivering returns. The SIC, as authorized by the Legislature, can justify an ETI's reduced level of expected financial return, with the expected economic development benefits that the investment are expected to deliver. The LGPF does not have ETIs in its portfolio and so is a better gauge of SIC's performance. The difference in return between the two is a rough approximation of the opportunity cost of these initiatives.

Peer Total Return Rankings. Chart 1 shows peer total return rankings for the agencies' large funds for the quarter, one, three, five, and ten-year periods. A lower rank (1st is best) denotes better performance when compared to other funds. All of the comparisons are made using the Wilshire Trust Universe Comparison Service (TUCS), a benchmark for the performance and allocation of institutional assets that includes approximately 85 public funds with more than $1 billion in assets.



	4rd Quarter	1 Year	3 Year	5 Year	10 Year
PERA	43	38	61	35	91
ERB	69	78	77	26	52
LGPF	48	38	55	48	73
STPF	43	53	65	63	93

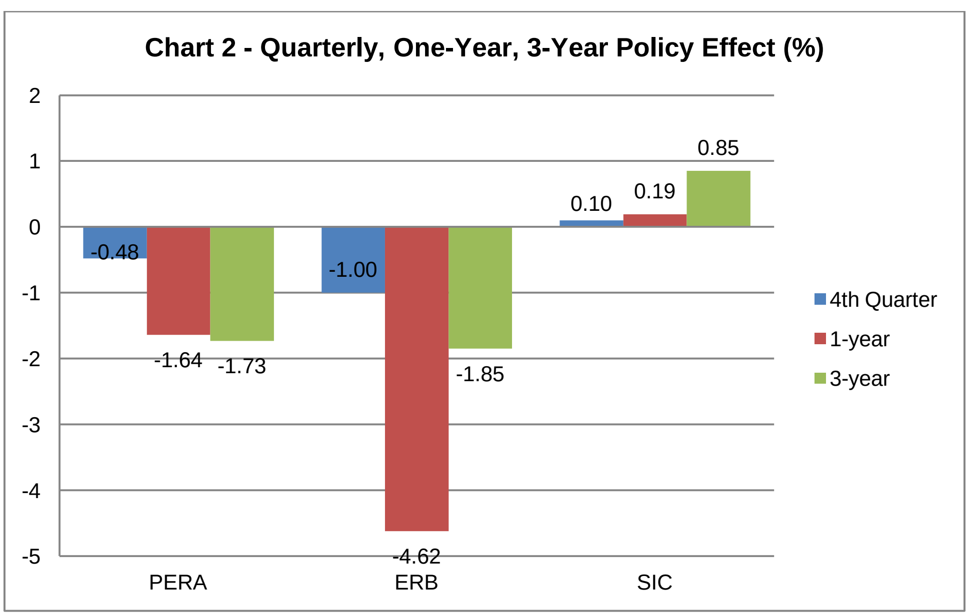
For the quarter, PERA's rank of 43 remained in the second quartile, lower than the ranking of its one-year performance, but better than its ranking over the last three, and ten years. PERA's ten-year ranking remains the second lowest of the four funds in the universe but their five-year ranking is the highest of all the periods for PERA.

ERB returned another subpar quarterly performance – its one- and three-year performance rankings improved but also remain subpar in the fourth quartile. The fund's five-year ranking saw a big gain over the previous quarter sitting just outside of the first quartile, while the ten-year shows a lower ranking than in the previous quarter (38th percentile).

Both funds invested by SIC saw a significantly higher performance in the current quarter compared to the previous quarter. The LGPF's quarterly and five-year performance moved from sub-par to just over par in the 48th percentile for both while the one-year term also improved to the 38th percentile. The three-year period ranked in the 55th percentile while the long-term ranking saw an improvement from the previous quarter to the 73rd percentile. The STPF's quarterly ranking showed significant improvement from the previous quarter as it sits on the lower end of the second quartile. Improvements were seen in the one-, five-, and ten-year periods; however, the fund's performance remains below average. As noted in the previous two quarters, the SIC restructured its portfolio by changing its asset allocation and individual investment managers in an effort to improve returns while lowering risk. SIC's improved results could be attributed in part to these changes.

Attribution Analysis. There are three basic ways that a fund's returns can differ from the average: the policy, allocation, and manager effects.

Policy Effect. A fund can have a long-term policy allocation (known as the "policy index") target that has a more or less aggressive proportion of risky assets such as stocks. For example, if risky domestic assets such as U.S. stocks (equities) performed well, an index that has more domestic equities should outperform the average. Measured in isolation, such a change in performance is known as the "policy effect," and it is an essential responsibility of the fund's trustees.



The most appropriate measurement of a policy allocation benchmark is a comparison to a defined peer group. Chart 2 shows the funds' policy effect as measured by comparing the funds' policy indices to the TUCS median fund actual return to allow uniformity and consistency across the three funds. The TUCS median return is gross of the allocation and manager effects, and the measure is therefore a rough estimate of the policy effect. (The investment agencies' policy target allocations are included in Figure 1, on page 8 of this report.)

PERA's policy allocation returned 0.48 percent less than the median fund in the quarter, 1.64 and 1.73 percent less during the one and three-year period, respectively. As was mentioned in the previous LFC investment report, PERA adopted new policy targets in 2012 that raised the domestic equity target from 27 to 29 percent, lowered the international equity target from 27 to 20 percent, lowered the absolute return asset target from 9 percent to 7 percent and added a "liquid alpha" allocation of 5 percent, which had no share of the portfolio allocation at the end of the last two quarters. In periods where equities perform well, PERA's 2012 changes to its investment policy that increased the allocation to the liquid alpha asset class in favor of equities may have resulted in a lower policy effect. However, this less risky and more diverse allocation could limit losses in periods where stocks do not perform well.

The SIC's LGPF policy calls for a 37 percent allocation toward domestic equities, and a 15 percent allocation toward non-U.S. equities. The SIC's policy allocation delivered 10 basis points above the median fund in the quarter, and 19 basis points above the median fund during the year. The policy delivered 85 basis points above the median fund in the three-year term, 32 basis points less than in the previous quarter.

In contrast to both PERA's and SIC's policies, ERB's policy calls for a lesser exposure to equities (37 percent) in favor of fixed income assets; this is because ERB is a relatively mature fund with relatively high near term payout commitments. ERB's quarterly policy index performed 90 basis points below the TUCS median fund performance, and the policy effect over the last year was -412 basis points. ERB notes the large effect for the one-year period is mainly due to the agency's lower policy weight in equities in general, and particularly in domestic equities, which performed well during the year. Further, ERB has a higher policy weight to emerging markets whose performance trailed that of developed markets[1], causing the higher allocation to hurt returns.

Allocation Effect. The second way that a fund's return can be affected is by deviation from asset allocations called for by policy. As a matter of practice, investment officers are constantly confronted with allocation decisions when transitioning or rebalancing portfolio managers or asset classes. Asset prices and values can vary in the short run, causing the allocation toward an asset class to drift from its long term target. Almost all rebalancing policies contain some flexibility for staff or the chief investment officer to operate within set boundaries. The three funds constantly see contributions coming in and distributions going out. Further, cash is being generated in some portions of the portfolio, and called or used in others, which can also cause asset allocations to deviate from policy. The investment officer may have the option of letting money sit in cash or incurring the cost of temporarily covering the allocation through the futures market or some other avenue, depending on policy authority. Rebalancing authority afforded the chief investment officer is dictated by investment policy, resulting in differing degrees of authority delegated by each fund.

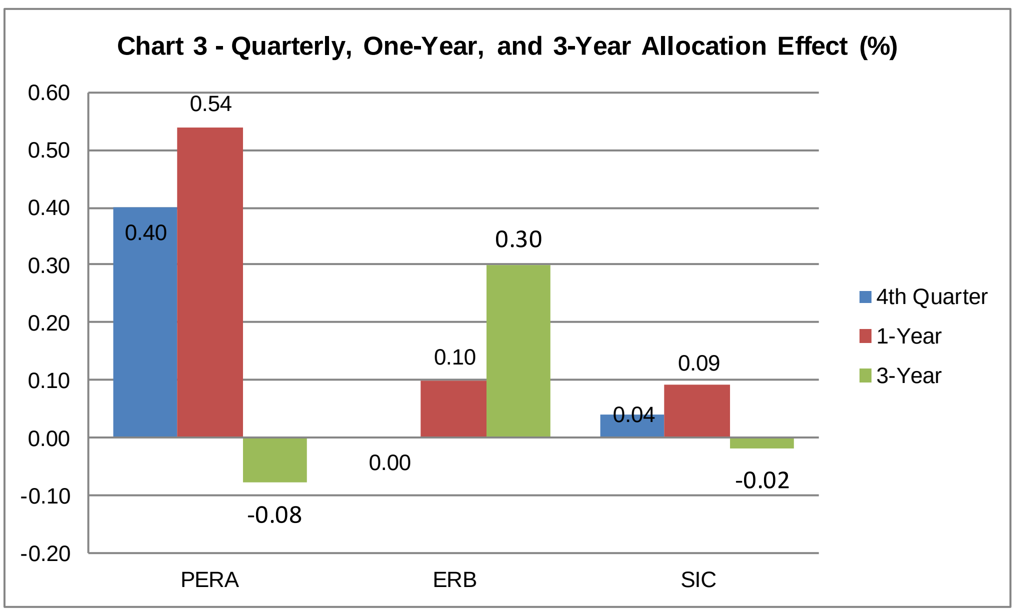
[1] http://blogs.wsj.com/moneybeat/2014/01/03/for-emerging-markets-2013-couldnt-end-soon-enough/

The difference between the funds' temporary and long-term allocation is known as the "allocation effect" and is interpreted as investment return added or lost. Chart 3 shows the allocation effect graphically for the quarter, one-year, three-year, and five-year periods.

PERA gained 40 basis points during the quarter due to an overweight in international and domestic equities despite underweight in real assets. As PERA's allocation continues the transition from equity to private assets, this overweight should decrease. In the one-year period, PERA gained 54 basis points due to underweight real assets and absolute return and overweight domestic and international equity.

ERB's fourth quarter allocation effect was 0. ERB's one-year allocation effect of a positive 10 basis points resulted from value gained by deviation from allocation targets in U.S. equities and opportunistic credit and offset by a reduction in value due to an underweight in the private equity allocation

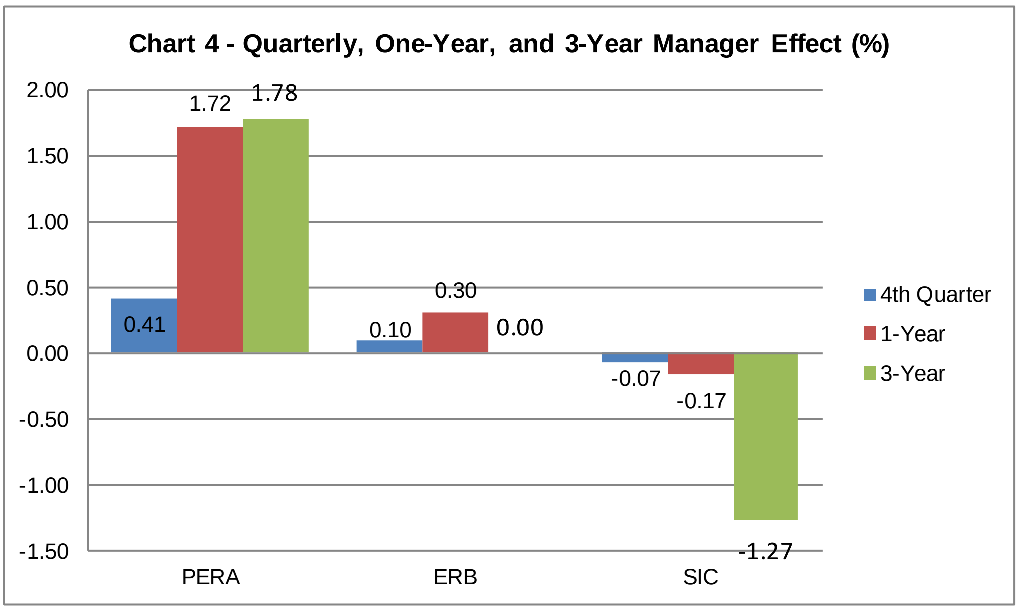
During the quarter, SIC's return was 4 basis points above the median due to deviations including underweight to non-U.S. equity, real return and to real estate, which offset value lost due to overweight in Fixed Income and cash. The one-year allocation effect for the SIC was a positive 9 basis points. Value added by underweight to real estate and to real return nearly offset lost value from overweight to fixed income assets. SIC notes that funds seek to minimize the magnitude of the allocation effect as deviations from policy do not tend to occur intentionally in an effort to increase returns. According to SIC, an over allocation to fixed income and cash equivalents hindered the portfolio, but overall asset allocation helped performance due to an overweight to US equity and underweight to non-US equity, real return, and real estate.



Manager Effect. The third way that value can be added or subtracted from a fund is through the use of active management. For instance, a fund can buy a security such as the institutional version of the Standard & Poor's Depository Receipts (SPDRS) commonly used by retail investors. These securities are composed of a relatively fixed basket of securities that track the S&P 500 index. Alternatively, the fund can employ a manager who will trade individual securities given his perspective of individual stocks.

This is known as "active" investing. The difference between the return of the index and the portfolio of the active manager is known as the "manager effect."

Chart 4 shows manager effects for all three agencies during the quarter, one-year, and three-year periods. PERA's managers contributed to a quarterly manager effect of 41 basis points; SIC[2] showed a loss of 7 basis points; and ERB's manager effect in the quarter was +10 basis points. PERA's 172 basis points manager effect was realized in domestic equities and fixed income assets. ERB's managers gained 0 basis points driven by offsetting gains and losses in opportunistic credit and GAA, respectively. SIC's one-year manager effect was a negative 17 basis points. Value added in fixed income, real return, and absolute return assets did not offset value lost in non-U.S. and private equity and real estate. SIC notes despite low asset class returns, fixed income managers added the most value to the portfolio in the fourth quarter. However, overall manager value add was negative.



Summary. The market environment and the funds' quarterly performance can be summarized as follows:

- After weaker performance across most asset classes in the first two quarters, global stock markets saw strong gains in the face of investor concerns regarding political negotiations of the federal budget. Like in the third quarter, the economy continued gaining positive momentum in the fourth quarter in part by signs real GDP has grown faster than expected (3.2 percent growth after increasing by 4.1 percent in the third quarter) and by an unemployment rate below 6.7 percent in December (lowest level since 2008) and an increase of consumer confidence above 78 points
- The U.S. stock market, represented by the Wilshire 5000 Total Market Index, posted a total return of 10.11 percent in the fourth quarter to post a remarkable 33.06 percent return for 2013, marking its best annual return since climbing 36.45 percent in 1995

[2] The SIC notes that its net-of-fees performance analysis is based upon an estimate of SIC's investment performance developed by RV Kuhns.

- Like in the previous quarter, all three agencies' one-year investment returns exceeded their respective long-term, target returns (Table 1). However, long term returns continue to fall below the targets
- PERA's quarterly returns were in the second quartile of peer funds. Returns were aided by positive allocation and manager effects. The fund's one-year performance was in the 38th percentile. During the one and three-year periods, PERA's investment managers substantial value through active management.
- ERB performance was driven by an investment policy that calls for a lesser exposure to equities in favor of fixed income assets. This less risky policy contributed to returns in the bottom third of peer funds in the quarter. Stocks performed well in the one-year period, and ERB's lower exposure to equities resulted in the fund ranking in the 78th percentile of peer funds, a gain of 10 spots from the previous quarter. Value was added by deviations from this policy
- Quarterly investment returns of the LGPF and the STPF ranked in the 48th and 43th percentiles, respectively. These rankings are significantly higher than in the previous quarter by 17 and 32 positions, respectively. However, a negative manager effect detracted slightly from returns in the quarter and one-year periods, and more significantly in the three-year period. Finally, while an underweight to non-US equity and real return helped improve STPF performance, an underweight to U.S. equity and fixed income hurt returns. The SIC also notes legacy issues from investments predating the current council are affecting returns, adding that some of these are in private equities with longer-term investment horizons.

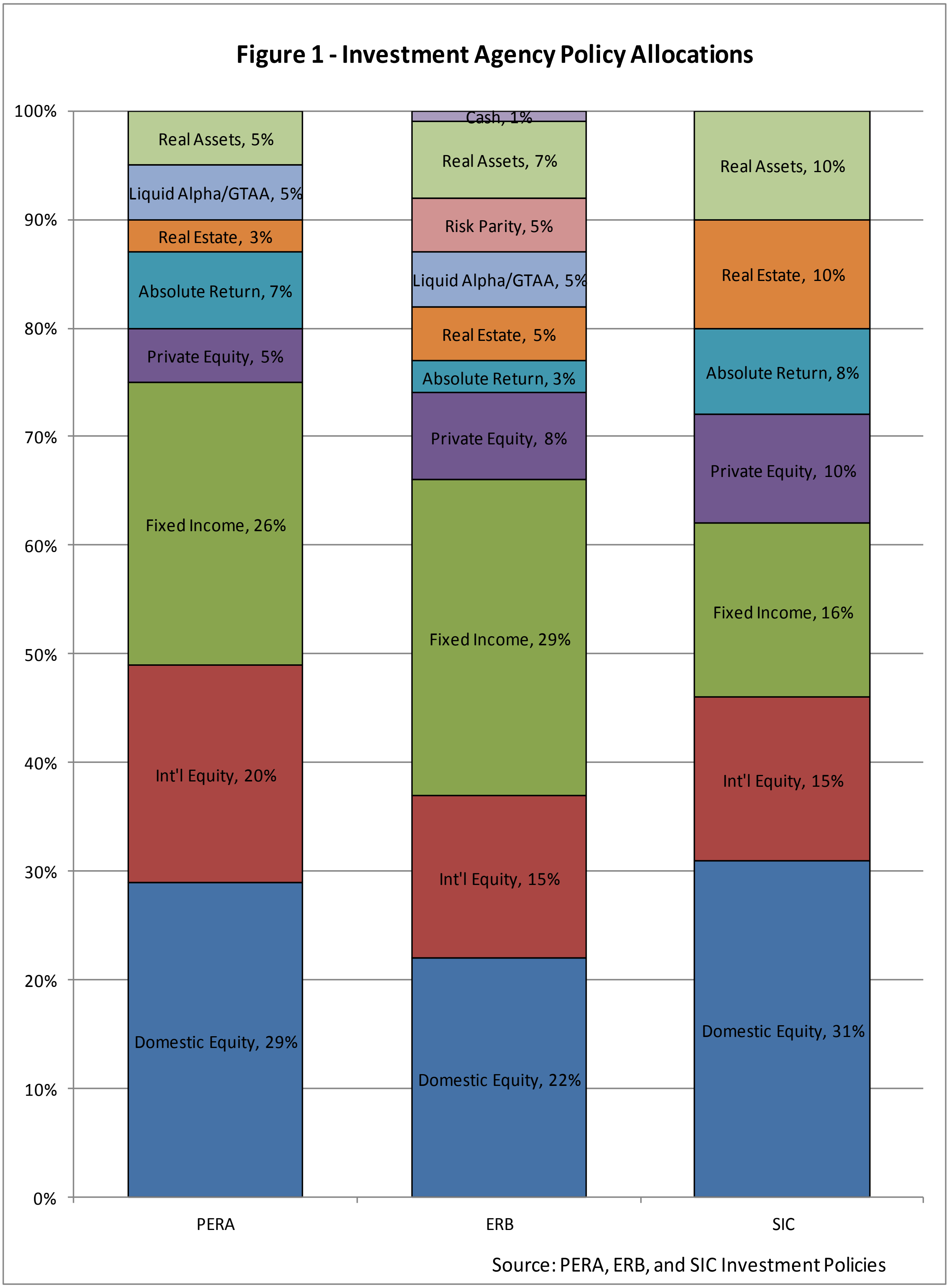


Figure 1 - Investment Agency Policy Allocations
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
PERA
ERB
SIC
Real Assets, 5%
Liquid Alpha/GTAA, 5%
Real Estate, 3%
Absolute Return, 7%
Private Equity, 5%
Fixed Income, 26%
Int'l Equity, 20%
Domestic Equity, 29%
Cash, 1%
Real Assets, 7%
Risk Parity, 5%
Liquid Alpha/GTAA, 5%
Real Estate, 5%
Absolute Return, 3%
Private Equity, 8%
Fixed Income, 29%
Int'l Equity, 15%
Domestic Equity, 22%
Real Assets, 10%
Real Estate, 10%
Absolute Return, 8%
Private Equity, 10%
Fixed Income, 16%
Int'l Equity, 15%
Domestic Equity, 31%
Source: PERA, ERB, and SIC Investment Policies